VI. APPENDIX

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SECURITIES EXCHANGE COMMISSION: Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisors and Mutual Funds, Sept. 22, 1998, http://www.sec.gov/news/studies/softdolr.htm.

Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds

September 22, 1998

The Office of Compliance, Inspections and Examinations
U.S. Securities & Exchange Commission

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3. Step-Out Transactions

Approximately 8% of the advisers that we examined used step-out transactions to fulfill their third-party soft dollar commitments. In a typical step-out arrangement, an adviser directs trades to a broker-dealer with the instruction that the broker-dealer execute the transaction and that another broker-dealer provide soft dollar products/services. The broker-dealer that provides the execution of the trade "steps out" of a portion of the commission in favor of the broker-dealer that provides the soft dollar product/service.

As mutual fund distribution becomes increasingly competitive, step-out trades have become an additional incentive used by fund advisers to reward broker-dealers for selling fund shares. Advisers who seek to do business with broker-dealers that have sold fund shares must still fulfill their duty of best execution, however, and must disclose the practice if it is a factor considered by the adviser in selecting broker-dealers.[76] The process of having an executing broker step out of a portion of a trade in favor of another broker can reduce or eliminate this conflict for an adviser. By telling a broker executing a trade to step-out a portion of the commission to another broker, an adviser can use the broker that provides best execution to execute the trade, and can pay commissions on the trade to other brokers from which it receives research or other services, even if those brokers have inferior execution capability.

A conflict would exist if an adviser asks executing broker-dealers to step-out of trades for its private clients to increase the compensation received by broker-dealers that are involved in distribution activities of shares of funds sponsored by the adviser. While we did not observe this scenario during the examination sweep, we will continue looking closely at this issue.

We noted that broker-dealer confirmations to advisers did not clearly indicate which broker-dealer actually executed the step-out trade, which broker-dealer received a step-out portion of the commission and what portion of the commission was stepped-out. This made it difficult for advisers to track their soft dollar payments made through step-out trades. This limited disclosure also raises concerns under the antifraud provisions of the federal securities laws and rules thereunder, particularly Rules 10b-5 and 10b-10 under the Exchange Act.[77]

Rule 10b-10 requires broker-dealers to send a written confirmation of each securities transaction with a customer at or before completion of the transaction, containing certain material information about the transaction. In a step-out transaction, Rule 10b-10 requires both the executing broker-dealer and the broker-dealer providing the soft dollar services to send a written confirmation containing all of the information required by the rule.[78]